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STUDIES ON RESTRICTIVE BUSINESS PRACTICES RELATED TO THE PROVISIONS OF THE SET OF PRINCIPLES AND RULES

The role of competition policy in economic reforms in developing and other countries

Study by the UNCTAD secretariat

CONTENTS

	Paragraphs
Summary and conclusions	1 - 9
Introduction	10 - 12
Chapter	
I. Competition and liberalization in countries undertaking economic reforms and the role of competition authorities	13 - 27
A. The role of competition policy in economic reforms	13 - 23
B. Experiences of some countries	24 - 27

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CONTENTS (continued)

		Paragraphs
II.	Competition and prices	28 - 61
	A. The advantages and difficulties of price liberalization and the role of competition authorities	28 - 38
	B. Horizontal RBPs and prices	39 - 43
	C. Vertical RBPs, dominant positions of market power and prices	44 - 49
	D. Pricing and natural monopolies	50 - 61
III.	Competition, privatization and demonopolization	62 - 82
	A. Privatization efficiency and competition	62 - 76
	B. The pace and modalities of privatization or PE reform	77 - 82
IV.	Competition policy and trade and foreign investment liberalization	83 - 106
	A. Effects of foreign direct investment upon competition	83 - 88
	B. Competition policy and foreign investors	89 - 94
	C. Effects of trade upon competition	95 - 96
	D. Competition policy and import trade	97 - 103
	E. International cooperation	104 - 106

SUMMARY AND CONCLUSIONS

1. Strengthening competition is a key element in ensuring the success of the deregulatory economic reforms adopted worldwide in recent years. For this purpose, market forces need to be supported by rules of the game. However, although several developing and other countries have adopted or are preparing competition laws and policies, many countries have yet to do so. The benefits of applying a competition policy in these latter countries, particularly during the transition before reforms induce self-correcting market forces, need to be better appreciated.

2. It would be desirable for competition authorities to both control RBPs by private firms and act as advocates for competition policy in the elaboration of other government policies. Competition policy should be applied in the light of the specific circumstances in individual countries, taking into account efficiency considerations and the need to create confidence within the business community. Priorities should be established bearing in mind inter alia the need to support and supplement economic reforms. Adequate resources should be provided.

3. Price liberalization has been a key measure of economic reform in many countries, although difficulties have been experienced with respect to its speed and sequencing with other reforms; where liberalization sets off an inflationary spiral, this can adversely affect competition. Ensuring firms do not reduce its beneficial effects by keeping prices artificially high should be an important task of competition authorities. However, care should be taken not to restore price controls in another form, which would adversely affect competition and efficiency.

4. In the application of competition laws intended to control RBPs affecting prices, horizontal price fixing and similar practices are usually proscribed per se or in principle, but other horizontal practices or joint ventures are sometimes exempted because of concerns about efficiency. Most countries with competition laws evaluate vertical RBPs in a case-by-case basis. Competition laws in developing and other countries have paid particular attention to behaviour by firms in dominant positions of market power. For the purpose of controlling prices or RBPs by natural monopolies, competition laws have been supplemented in some countries by various forms of industry regulation. However, applying such controls in an optimum manner is difficult, and countries that are embarking on such an endeavor will benefit from technical cooperation from countries with experience in this area.

5. Privatization in developing and other countries often increases efficiency, but this is not necessarily always the case, particularly in countries with limited resources of capital or skills, or without the structures to ensure competition or managerial accountability. Privatization should be integrated into the overall context of economic reform and phased in line with the economy's absorptive capacities, with competition authorities assisting in evaluating how best to privatize in a manner that promotes competition and efficiency and screening any incentives, subsidies or regulatory protection granted in this context. Such methods of privatization as contracting out may yield good results. Prior to privatization, public enterprises should, to the extent possible, be reformed and exposed to competition.

6. Because of their often superior competitiveness, the entry of foreign investors into the markets of developing and other countries would usually have extensive effects in either increasing or reducing competition, as well as in increasing efficiency. In exercising control over the RBPs of foreign investors, special vigilance is required over foreign investors, national treatment should be adhered to. The application of such controls would not usually act as a deterrent to foreign investors and may provide them with stability and security. Because foreign

firms often have strong market power, special vigilance is required and it may sometimes be more effective to reduce market entry barriers. Investment incentives, subsidies or special protection for foreign investors should be controlled, in consultation with competition authorities.

7. Imports are critical to ensuring there is competition in the markets of developing and other countries, although they have some limitations in this respect. Competition authorities should take into account the effects of imports upon the domestic market and should control RBPs that reduce their beneficial effects, including through abusive exercises of intellectual property rights, or pricing abuses by foreign exporters. Recourse may sometimes be needed to exercises of extraterritorial jurisdiction, but it may be difficult to enforce. Competition authorities might also advocate trade liberalization where appropriate, although such advocacy may be ineffective unless they can induce confidence in their ability to control RBPs by foreign exporters and unless there is an open and pro-competitive international trading system.

8. Trade and foreign investment liberalization, while increasing international competition in many sectors, may reinforce oligopolistic global market power in others, particularly some high technology sectors. This may be difficult for individual competition authorities to control. Strengthened cooperation among competition authorities would assist in ensuring the accountability of such oligopolistic global firms, in minimizing competition and trade tensions among countries and in protecting global competition. Such international cooperation could take the form of greater convergence in trade-related aspects of competition policies, co-ordinated enforcement, mutual assistance and a system for allocation of jurisdiction (where appropriate) amongst national competition authorities. Arrangements along these lines would be in the common interest of all countries and would support the economic reform efforts of developing and other countries.

9. In the light of the above, actions by States should include:

(a) the adoption, improvement and effective implementation of competition policies by developing and other countries, integrated into the framework of their economic reforms;

(b) establishing appropriate mechanisms to control RBPs or pricing by natural monopolies and to ensuring that privatization does not result in the replacing of public monopolies by private monopolies;

(c) examining the competitive effects of foreign direct investment and trade;

(d) providing technical cooperation to assist such endeavours;

(e) fully implementing all provisions of the Set of Principles and Rules, in order to ensure its effective application; and

(f) consultations in the context of the Intergovernmental Group of Experts on the appropriateness of, and modalities for strengthening bilateral, regional and multilateral cooperation mechanisms in the area of competition policy.

INTRODUCTION

10. The present study has been prepared in accordance with the agreed conclusions adopted by the Intergovernmental Group of Experts on Restrictive Business Practices at its eleventh session, and is based on an outline approved by the Group[1]. The study examines the relevance and potential contribution of competition policy to the process of economic reform taking place in developing and other countries, in terms of both control of restrictive businesses (RBPs) and competition advocacy by competition authorities. Particular reference is made to policies relating to prices, de-monopolization and privatization and foreign investment and trade.

11. Chapter I brings out how economic reform and liberalization may be supported and supplemented by competition policy and suggests some approaches and priorities that might be adopted by competition authorities for this purpose. Chapter II discusses the economic effects of price liberalization and how Governments have attempted to ensure that its benefits are not lost through horizontal or vertical RBPs or the behaviour of natural monopolies. Chapter III discusses the relationships among competition, privatization and efficiency, the benefits obtained and problems experienced in the privatization process and the pace and modalities for privatization and reform of public enterprises. Chapter IV examines the relationships among competition and liberalization of direct foreign investment and import trade and discusses the specificities involved in the application of competition policy to foreign investors and to overseas firms. The need for policy coordination in this area, at both the national and the international levels is emphasized.

12. Throughout the study, references are made to an earlier study made by the UNCTAD secretariat entitled "Concentration of market power in the markets of developing countries through mergers, joint ventures, and other acquisitions of control, and its effects on international markets, in particular the markets of developing countries" (TD/B/RBP/81/Rev.2), hereinafter called the Concentration study. It should also be noted that issues relating to privatization in general are being addressed in the Ad Hoc Working Group on Privatization.

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[1] See report of the Intergovernmental Group of Experts on Restrictive Business Practices on its eleventh session (TD/B/39(2)/7), annexes I and III.

Chapter I

COMPETITION AND LIBERALIZATION IN COUNTRIES UNDERTAKING ECONOMIC REFORMS AND THE ROLE OF COMPETITION AUTHORITIES

A. The role of competition policy in economic reforms

13. Fundamental economic reforms have been adopted worldwide in recent years, many of them motivated by a growing recognition of the role of the market and of the private sector in the efficient functioning of economies at all stages of development. In developed countries, various regulations affecting prices, market entry or exit and monopolies, as well as the ambit of RBP laws, have been liberalized or reformed, and large privatization programmes have been implemented in a number of them. In many developing countries, efforts are under way to pursue market-oriented reforms, including structural or sectoral reforms of varying degrees of ambition, notably in areas of trade policy, investment policy, privatization and, where applicable, deregulation (including the reduction of subsidies, administrative allocation of key production inputs, price controls, establishment and capacity licensing requirements, exclusivity arrangements and exit barriers). In former centrally-planned economies, far-reaching institutional changes have been accompanied by moves to market-based economic systems integrated more closely into the world economy. Such reforms in a large number of countries have by no means been finalized; although major efforts have been made, an immense task still lies ahead.

14. A common aspiration underlying these reform efforts is that the reduction of governments' direct involvement or intervention in economic activity would, by exposing enterprises to more freedom and stronger incentives, stimulate entrepreneurial activity, business efficiency, productive investment and economic growth, as well as lead to speedier and more adequate satisfaction of consumer demands. Throughout the economy, therefore, productive resources would be allocated in an efficient and flexible manner through the decentralized decisions of market operators rather than by government direction or through rent-seeking activity. However, such aspirations are likely to be fully realized only if enterprises act under the spur of competition so that consumer dissatisfaction serves as a market sanction for poor performance. Thus, the strengthening of competition is a key element in ensuring the success of economic reforms.

15. Largely for such reasons, several developing countries[2] and countries of Central and Eastern Europe,[3] have adopted competition laws or reformed existing laws in recent years, while several more countries are in the process of doing so. Yet many other countries which are undertaking economic reforms have neither competition laws nor even explicit competition policies. While this may be due, to some extent, to lack of information by policy-makers, but there may also be a reluctance to adopt competition laws because of the feeling that competition controls would restrict business activity and market forces and thus go against the trend towards economic liberalization, which would suffice by itself to ensure a competitive market. There may

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[2] Including Argentina, Brazil, Chile, Colombia, Côte d'Ivoire, Gabon, Kenya, India, Jamaica, Mexico, Pakistan, Peru, Republic of Korea, Sri Lanka, Thailand, Tunisia and Venezuela.

[3] Including Bulgaria, the Czech Republic, Hungary, Lithuania, Poland and the Russian Federation.

also be concerns about weakening the market position of domestic enterprises at a time when they are faced with difficult challenges, about deterring foreign investors and about the difficulties and costs to enterprises of complying with reporting or investigatory requirements, which would give rise to complaints about "red tape". There may be doubts about the ability of competition authorities to detect or to prove RBPs, given the difficulties involved in a developing country environment. Finally, the creation of a new regulatory body to implement competition policy would involve costs for governments at a time of budgetary stringency. Some answers to such concerns are suggested below, as well as some approaches to competition policy implementation that may help to strengthen the relevance of competition policy in the context of reform in developing and other countries.

16. Although liberalization of regulatory barriers should increase opportunities for competition, such barriers are still likely to play a role for some time to come, while liberalization policies alone will not suffice to overcome other disincentives to market entry. As was brought out in the Concentration study, domestic markets in most developing countries are usually highly concentrated, because the level of demand in these markets can sustain relatively few firms producing on a minimum economic scale. Other disincentives include the limited availability of entrepreneurs and of production inputs, inefficient distribution and communications systems and poor information flows. This is also the case in several countries of Central and Eastern Europe, where vertical integration is particularly high. The adoption and implementation of competition safeguards are particularly important in countries which are in the process of building up market mechanisms and institutions. It often happens, for example, that countries undertaking stabilization and structural adjustment programmes implement reforms in phases, either because differential phasing is built into their programmes or because some reforms are off schedule. For example, they may implement some fiscal and monetary reforms (such as price decontrol, tariff reform and devaluation) rapidly, whereas institutional ingredients of their programmes, particularly aspects of domestic deregulation, public enterprise reform and privatization, may not be in place for several years. In such circumstances, there would be a lag before reforms would generate sufficient competition to create self-correcting market forces.

17. In the interim, incumbent firms may take advantage of deregulation to engage in RBPs previously prevented by government intervention and to block market entry. Not only may this happen in sectors where incumbent firms already have a market-dominating position, but there may be expansion by such firms into other newly deregulated industries. The problem is not merely a transitional one; once firms have been allowed to entrench their positions through anti-competitive conduct or structures, it may be difficult to take corrective action without damaging the economy and business confidence in the process. In this context, it is sometimes argued that the development process is best served, at least initially, by efficient monopolies and that competition can be introduced at a later stage through deregulation. However, this under-estimates both the positive effects of competition upon efficiency and the difficulties of taking ex post facto corrective action rather than preventive action.

18. Experience has shown that the attainment and maintenance of competitive markets cannot be done through complete laissez-faire, but requires "rules of the game". The more one removes direct government controls over the economy, the more one must work to ensure the maintenance of competition in their place. Thus, even the most advanced countries, which have long adhered to liberal economic policies and which have large markets where entry is relatively easy, have found it necessary to maintain active competition policies and to keep adapting them to new challenges. Controls upon RBPs by some firms preserve the overall freedom of all enterprises to conduct their businesses in a legitimate manner, and also protect consumer

welfare, thus providing a healthy and supportive climate for economic activity.

19. Moreover, competition policy in its broad sense is concerned not only with private but with regulatory restraints upon market forces, in which respect it coincides with economic liberalization policies, but also enables such policies to be designed and implemented in a manner which takes into account the linkages between governmental and private restrictions. In all countries with competition laws, the competition authorities control the RBPs of enterprises. In some of these countries, these authorities also advocate measures to safeguard competition in the formulation and implementation of other government policies. This advocacy function is important in countries where a competition philosophy may not be completely understood or accepted. In the absence of a well-articulated competition doctrine, there is a heightened risk that individual firms which are, in principle, favourable to liberalization, will successfully lobby against liberalization measures which adversely affect their interests.

20. This does not mean that competition policy should be formulated and implemented in a doctrinaire and inflexible manner. In several countries which have had long experience in this field, action against RBPs is undertaken on the basis of thorough economic analyses taking into account behavioural factors rather than just market share data, including possibilities for product substitution and market entry and the impact of technological change. Efficiency gains may be taken into account, as well as competition from imported goods and (in some countries) the competitiveness of national firms vis-a-vis foreign firms in domestic and overseas markets. Moreover, in several competition laws, exemptions from RBP controls (or relatively lenient controls) may be provided for some types of practices or joint ventures, or for some industrial sectors (particularly declining or high-technology sectors), because of considerations of efficiency, industrial policy or competitiveness. Competition would usually be the main criterion, but other public interest criteria would not be lost sight of. In many countries with competition laws, competition principles are also sometimes not fully adhered to in such areas as trade, industrial policy, public procurement, or subsidies.

21. In the context of developing or other countries undergoing economic reform, proper economic analysis and flexibility in applying competition policy may be even more necessary so as not impede efficiency, growth or development goals. This is recognised in the Set of Principles and Rules, which provides for preferential or differential treatment for developing countries in this area, and for account to be taken, in the control of RBPs, of the development, financial and trade needs of developing countries, for the purpose especially of promoting the establishment or development of domestic industries and the economic development of other sectors (para. C.7). Competition policy should be applied in an impartial and independent manner, but it cannot operate in a vacuum divorced from the pressing realities of countries undergoing economic adjustment; otherwise, it might be brushed aside as irrelevant. Pragmatic compromises may be justified in the short term, as long as the momentum of progressive movement towards competitive markets is maintained.

22. Competition authorities should pay more attention to the likely effectiveness and to the quality rather than to the quantity of their interventions. The choice of priorities will vary in accordance with the circumstances of each country, the resources available and the exact functions and powers of the competition authority. Intervention might be most appropriate in the areas of prices, privatization, import trade and foreign investment, as discussed in the following chapters. Other areas for intervention might be chosen on the basis of the scope for consistency feedback and synergy between competition policy and other policies. Thus, for

example, competition autthorities might intervene in respect of government policies reducing the effect of RBP control measures, while enforcement efforts might focus on economic sectors which have been deregulated, but where effective competition has not yet arisen. Priorities in enforcement might also be decided on the basis of which RBPs are particularly prevalent or harmful in the context of individual countries, or are easy to detect or evaluate; thus, for a new RBP control authority, practices subject to outright prohibitions may be easier to deal with than practices requiring complex economic analyses.

23. The effective implementation of competition law depends to a large degree upon whether the business community has confidence in the regulatory system and perceives it as a facilitator of the competitive process rather than as a hindrance to efficient business operations. Generating such credibility is particularly important in the early years of developing a competition system and would be assisted by the use of intelligible standards and rules and fair, speedy and efficient procedures. Appropriate pedagogical efforts, both within the government and vis-à-vis the public and enterprises, may be a means of demonstrating that a free market is not a free good and that, even in conditions of financial stringency, governments should provide adequate resources for this task (moreover, substantial savings may accrue to the government from controls on RBPs affecting public procurement). Technical cooperation in this domain from the international community would be useful in training staff with the requisite skills.

B. Experiences of some countries

24. The experiences of the Republic of Korea and Poland provide examples of how competition policy may be integrated into economic reform and liberalization policies and how competition authorities may undertake active competition advocacy and RBP control functions. In the Republic of Korea, the "Sixth Five-Year Economic and Social Development Plan", adopted in 1986, aimed at promoting competition based on free market principles through policies of deregulation, enforcement of the Antimonopoly and Fair Trade Law of 1981 and liberalisation of imports and of financial services.[4] There has been extensive liberalisation of systems of price control, business licensing, industry regulation and support, State ownership of enterprises and restrictions upon foreign investment and imports. The competition law requires other government authorities to consult with the Minister of the Economic Planning Board when they wish to introduce, amend, or enact any legislation or order that might restrain competition. The Fair Trade Commission has actively exerted efforts to prevent the introduction of new restrictive regulations by reviewing legislation before its enactment, made efforts to eliminate existing anti-competitive regulations, and, with respect to markets controlled by dominant firms, advocated the elimination of entry barriers and the introduction of foreign competition[5].

25. As the economy is characterised by high a concentration of market power in large conglomerates known as "jaebol", competition enforcement has given priority to controlling market structure and RBPs by the "jaebol", while taking account of the high dependence of the economy upon them. Thus, the Fair Trade Law proscribes "business integrations" likely to substantially restrict competition, although exemptions are provided where the aim is to rationalize or to strengthen the international competitiveneness of an industry. Priority has also

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[4] See "Corporate Policies in the Republic of Korea" (UNCTAD/ITP/65).

[5] See "Monopoly regulation and fair trade in Korea", Fair Trade Commission, Republic of Korea, 1991.

been given to controlling collusive activities of firms and RBPs by trade associations.[6]

26. In Poland, the Economic Transformation Programme which was put into effect as from January 1990, was a standard stabilization programme involving price liberalization, cuts in subsidies, reductions in government expenditure, privatization, devaluation and trade liberalization. As it was being implemented in a formerly centrally-planned and state-dominated economy, however, its scope was vast; moreover, its components were speedily and simultaneously implemented, applying a "big bang" rather than a gradualist strategy for the transition towards a market economy. The economic reforms created new opportunities for privately-owned small and medium-sized enterprises (SMEs), which grew fast, but large public enterprises (PEs) experienced great difficulties. Overall, there was a sharp initial drop in industrial output and economic growth, accompanied by hyperinflation. However, the overall economic situation has improved since mid-1992; inflation, although still high, has stabilized[7]. PEs have now substantially improved their performance[8]. It was in this climate that the Law on Counteracting Monopolistic Practices of 1990 was adopted. In addition, the Government Programme on Competition Development 1991-1993 emphasises the importance of competition law enforcement, trade liberalization and privatization and requires Ministries and other government agencies to prepare and enforce their own programmes of competition development.

27. The Antimonopoly Office has issued numerous opinions in response to proposals for enactment of legislation submitted by ministries and agencies[9] and participated in work on establishing competitive market conditions. Emphasis has also been placed on control of abuse by firms holding dominant or monopolistic positions, as well of cartels and market allocation. But the Office, while it has the power to monitor and control restructuring in the process of privatization and the division of dominant firms, has been cautious about putting into effect a broad, radical demonopolization policy because of the great difficulty of finding the proper balance between a more competitive structure and possible loss of economies of scale and scope. In line with the government's industrial policy aims of protecting Poland's best companies and certain small companies, the Office accepts some exemptions from competition law requirements, but only if they are related to restructuring efforts and are for a limited and clearly defined period[10].

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[6] See the statement of the delegation of the Republic of Korea in TD/B/39(2)/7, p. 13.

[7] See "Survey Eastern Europe", The Economist, 13 March 1993.

[8] See B. Pinto, M. Belka, and S. Krajewski, "Transforming State enterperises in Polan: microeconomic evidence on adjustment", Policy Research Working Paper 1101, World Bank, March 1993.

[9] See Annual Report on Activity of the Polish Antimonopoly Office, 1992.

[10] See "Hungary, Poland balancing competition, need to protect firms during transition", Antitrust and Trade Regulation Report, Vol. 63, p. 63, 9 July 1992.

Chapter II

Competition and prices

A. The advantages and difficulties of price liberalization and the role of competition authorities

28. Accurate price signals facilitate efficient and flexible resource allocation at both macro- and micro-economic levels. On the demand side, prices should identify both the extent to which demand for individual products is being met by supply and the strength of relative demand for different products. On the supply side, prices should cover production costs and identify the optimal usage of different factors of production. This would stimulate new production and/or market entry in sectors where demand is stronger and discourage production in sectors where there is over-capacity. Efficient pricing and resource allocation would also require that account be taken of the international prices of traded goods and the resource and economic opportunity costs of domestic production, particularly where it might be cheaper to import.

29. The advantages of accurate pricing are great in countries with scarce resources, since the need for efficient resource allocation is greater in such. Yet precisely because of the scarcity of resources in these countries, developing and other countries often aimed in the past at minimizing (through subsidies) the prices of products which met the basic needs of low-income sections of the population, or which were production inputs for sectors governments were trying to promote. The high price distortion in these countries adversely affected competition and efficiency. In the Republic of Korea, price controls gave rise to deterioration of procuct quality, chronic excess demand, limited capital investment and sharp price fluctuations[11]. In Brazil, by institutionalizing the frequency and method of price setting, controls not only precluded price competition, but induced explicit and tacit collusion among firms, both when price controls were in effect and after they were eliminated[12].

30. A central element in many economic reform programmes has therefore been a range of price liberalization measures. These have ranged from immediate abolition to more gradual dismantling of price controls in respect of consumer products, often linked with the reduction of State subsidies and import tariff rates and the liberalization of prices for labour, energy, land, capital and foreign exchange (the latter usually involving devaluation or floating of the local currency). Such measures have resulted in price rises and inflationary pressures in the countries adopting them, although the scale and speed of the price rises have varied in accordance with the country and product concerned. However, it has been hoped that the stimulus provided to new production or market entry from the prospect of greater profit would eventually serve to stabilise or even to reduce prices.

31. Such hopes have been realised in some countries. In India, for example, where price and distribution controls had insulated producers from competition and from the need for modernization and cost reductions, beneficial results were obtained from price liberalization in

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[11] See "Corporate Policies in the Republic of Korea", op. cit.

[12] See Frischtak, C., "From monopoly to rivalry: policies to realize the competitive potential of transnational corporations", in Transnational Corporations, vol. 1, no. 2, August 1992, p. 57.

such sectors as cement[13]. However, in many countries, while the speed of adjustment in asset markets after liberalization has usually been swift, the adjustments in commodity and labour markets, let alone the production response that follows from new investment, have been much slower.[14] Where liberalization has set off an inflationary spiral, slow market entry or production responses to economic reforms has been contributed to by the reluctance of entrepreneurs to make heavy investment commitments because high inflation makes it difficult to assess the demand/supply picture. But partial price adjustments have sometimes been worse for inflationary expectations than a one-time large adjustment and also prevented a rational system of relative prices from emerging. In general, however, experience from hyperinflation and high-inflation episodes in different countries indicates that a speedy and simultaneous "big bang" approach to price liberalization only at the initial inflation stabilization stage[15].

32. In several Eastern European countries, the effect of liberalization has been a speedy and sharp reduction in output from large PEs, without a corresponding increase in supply responses by other producers, accompanied by high inflation. To some extent, this may have been unavoidable because formerly goods were being produced which were not in demand and because of monetary overhang and price distortions. But there has also been monopolistic behaviour by PEs anticipating future price controls[16]. Liberalization has so far failed to result in a price system that correctly reflects cost and/or demand conditions. It is becoming increasingly apparent that, in many formerly centrally-planned economies, it will be difficult to contain inflation without restructuring, demonopolising and privatising industries or firms; as the Ukraine's minister for the economy has noted, "a pure monetary approach which looks very good on paper is nearly impossible to implement in an almost entirely monopolised economy"[17]. Yet, until market prices have emerged, it may be difficult to identify which PEs are capable of being reformed and privatized and which ones would have to be liquidated. Moreover, inflation would have a dampening effect on the interest of potential acquirers of PEs. In Bulgaria, for instance, high inflation and interest rates have made the privatization process much more difficult[18]. Some suggestions for coping with such dilemmas in the areas of privatization and demonopolization are made in the following chapter.

33. In developing and other countries undertaking price liberalization, competition from imports has usually assisted in containing inflation and in disciplining of high prices by incumbent

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[13] See "India - An industrializing economy in transition", World Bank, 1989.

[14]See Trade and Development Report, 1993 (UNCTAD/TDR/12), Part Two.

[15] See Bruno, Michael, "Stabilization and reform in Eastern Europe - A preliminary evaluation", IMF Staff Papers, Vol. 39, No. 4, December 1992, p. 741.

[16] Ibid. See also UNCTAD/TDR/13, p. 157.

[17] See "Bottom-up style in fashion for ex-Soviet reform", Financial Times, 18 January 1993.

[18] See UNCTAD secretariat report "Design, implementation and results of privatization programmes: a cross-country analysis of national experiences" (TD/B/WG.3/7), pp. 11-12.

firms, whether these arise from inefficiency or from taking advantage of monopolistic positions. However, this contribution has been limited by certain factors, including the effects of devaluation in raising the prices of imported goods. It has been suggested, for instance, that the current economic improvement in Poland could have been achieved with lower inflation if these had been a smaller initial devaluation, as well as the establishment of price controls at a higher level for a limited time[19].

34. Some selected exceptions to price liberalization may be justified. There may be a case in particular for liberalizing prices for finance in a gradual manner, so as to encourage new production or market entry and to avoid financial instability in the reform process. Some limitations on competition in this sector may be justified; in Sri Lanka, maximum interest rates that may be offered to depositors by finance companies have been established in order to prevent "excessive competition" between finance companies to obtain deposits, leading to risky high interest loans and financial instability[20].

35. Exceptions may also be justified for purposes of industrial promotion. However, great care would need to be exercised in utilizing subsidies or incentives in developing or other countries, taking into account their often negative consequences in the past and the risks of distortion of resource allocation. If a government decides to adopt a gradualist approach to structural adjustment, subsidies should be given only to potentially profitable enterprises, calculated on the basis of newly set higher prices and be limited, transparent, time-bound and tied to restructuring efforts, while competition authorities should take into account any resulting distortions to competition. Some newly industrialised countries, for instance, have selectively intervened to promote particular industries, with varying intensities and success, but usually conditioning such intervention upon performance and efficiency improvements by such industries. In several developed countries, subsidization or incentives in some high technology or declining industries and in agriculture is also prevalent. Industrial subsidies which may affect competition within the European Community are controlled by the competition directorate of the European Commission. The question of subsidies and incentives is further dealt with in chapters III and IV.

36. Irrespective of the speed of price liberalization in different sectors at different stages of the reform process, or its sequencing with other economic reforms, competition authorities in developing and other countries have a key role to play in this process. They might advocate the beneficial effects of liberalization in general, and yet assist in identifying specific sectors where it may not be appropriate in the short term because of particularly imperfect market conditions (this latter function would entail monitoring of such sectors to assess when the time is ripe for liberalization). The enforcement efforts of competition authorities might also be focused and timed to mitigate adverse effects of price liberalization on sectors which are deemed particularly important. Thus, for example, any economic sector directly or indirectly catering for the basic needs of consumers, particularly the poorest among them, or which has a pervasive impact upon efficiency throughout the economy, might receive special attention. In Poland, for instance, the Antimonopoly Office takes into account price increases in deciding which sectors to examine; a

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[19] See Bruno op. cit.

[20] See "Corporate behaviour in restraint of trade in goods and services in Sri Lanka" (UNCTAD/ITP/64).

rapid increase in sugar retail prices led to an analysis of prices in this market, together with investigations of firms trading in sugar.[21]

37. Governments, which have greatly reduced their direct measures to keep prices down, object to efforts by enterprises to keep prices higher than they should be in a fully competitive market. However, liberalization necessarily entails some sacrifices and risks and it is legitimate for producers to seek to recoup their increased costs through price rises: unless they are given the freedom to do so, the supply situation will not improve. Given market imperfections, it has sometimes been difficult to ascertain whether high prices are due to RBPs or to unavoidable demand/supply imbalances or high costs. Efficiency considerations have also sometimes led to toleration of arrangements affecting prices, on the grounds that cost savings from efficiency improvements may be eventually be passed on to the consumer. Thus, for example, although monopolistic market structures may result in sub-optimally low output and high prices (which can be selectively lowered to deter market entry), and oligopoly may have similar effects because of the potential for collusion, an oligopolistic market structure may provide the best guarantee of both effective inter-firm rivalry and efficiency in sectors where the optimum size of firms is large, while the threat of market entry may have effects similar to actual entry.

38. The criteria which need to be taken into account by competition authorities in this area are enunciated, for example, in Sri Lanka's competition law, which provides for the Fair Trading Commission, in the exercise of its functions, to have regard inter alia for the protection of consumer interests, the provision of necessary incentives to producers, the necessity for ensuring reasonable rates of return on production capital, the allocation of resources among different sectors, the control of inflation and other objectives of economic and social policy[22]. The Commission now only controls prices of a few food and pharmaceutical products. However, it has the power to review the prices of any article after holding an inquiry and to determine whether the price is unreasonable, in which case it may recommend import tariff adjustments to encourage competition from imports; no such recommendations have been made in the eight enquiries carried out up to last year[23]. An investigation of pricing by a firm having a monopoly in the market for glass bottles found that price rises were due to cost increases; however, an undertaking was obtained in respect of quality control of the bottles.[24]

B. Horizontal RBPs and prices

39. Among the various types of conduct addressed by RBP control laws, none are viewed more widely as fundamentally incompatible with the viability of competition than horizontal price fixing (including through collusive tendering) and the practices that support it, such as the allocation of markets, customers or sales or production quotas. Horizontal price fixing or

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[21]See "Annual Report...", op.cit.

[22] See section 6, Fair Trading Commission Act, No. 1 of 1987, as amended.

[23] See "Replies by States and regional groupings on steps taken to meet their commitment to the Set of Principles and Rules" (TD/B/RBP/89).

[24]Information provided by the Government of Sri Lanka.

collusive tendering is often illegal per se or in principle, and may attract criminal penalties. In Brazil, for instance, crimes against the economic order which are proscribed include inter alia price-fixing, production quotas and market allocation; these RBPs are also among those proscribed or subject to approval requirements under the ordinary competition procedures[25]. Similarly, the Kenyan law makes collusive tendering a criminal offence unless it is a joint tender disclosed to, and acceptable to, the persons inviting the tender[26].

40. However, the approach taken to determine the legality of other horizontal RBPs has been less strict. Their legality may be evaluated in the light of efficiency, industrial policy, trade, public interest or "rule of reason" considerations. Thus, cartels may be allowed in some countries for purposes of rationalization of activities, specialization because of crisis conditions or a depression in an industry, or if they increase the bargaining power of SMEs vis-à-vis large monopsonistic buyers or for reasons of public welfare. Export cartels having no effect on the domestic market are also exempted from the application of competition law or are subjected in some countries merely to notification or registration requirements. In practice, it has sometimes also been difficult to distinguish between cartels and joint ventures, especially since joint ventures may sometimes involve ancillary restrictions. Research and development joint ventures, for instance, are usually exempted to some extent; in the EEC, joint exploitation of research results is also exempted.

41. In the Republic of Korea, horizontal "unreasonable concerted activities" are prohibited unless registered with and accepted by the Economic Planning Board, which will consider whether they lead to "a substantial restriction of competition in any particular field of trade against the public interest"[27] (the law does not apply to enterprises in agriculture, fisheries, or mining). Thus, when six major petroleum refinery companies collaborated in restricting sales by each company, the Fair Trade Commission fined them $3 million[28]. However, the Commission can permit concerted activities where unavoidable for purposes of industrial rationalization, of overcoming an economic decline in an industry which is restructuring, or of enhancing the competitive strength of SMEs and rationalizing the terms of transaction, subject to safeguards against unreasonable restrictions upon competition. Separate legislation provides for three-year rationalization programmes for declining "sunset industries" and growing "sunrise" industries, which qualify them for government assistance which is conditional upon efficiency improvements; the programmes must include plans for necessary cartel activities and (in the case of sunset industries) mergers, and market entry is restricted[29].

42. In Germany, the competition law[30] provides as a general principle that agreements made

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[25] See Law No. 8137 of 27 December 1990 and Act No. 8158 of 8 January 1991 instituting provisions for the protection of competition and other measures.

[26] The Restrictive Trade Practices, Monopolies and Price Control Act 1988.

[27] See Arts. 11 & 12 of the Monopoly Regulation and Fair Trade Act.

[28] See "Monopoly Regulation and Fair Trade in Korea", Fair Trade Commission, 1991.

[29] See "Corporate policies in the Republic of Korea", op. cit.

[30] The Act Against Restraints of Competition of 27 July 1957.

for a common purpose between competitors shall be of no effect, insofar as their implementation restricts competition and thereby has a perceptible influence on market conditions. However, several types of cartels may be legalized, provided they follow the appropriate procedures, which depend on the type of cartel involved; some cartels merely involve notification to the competition authority ("notification cartels"), others may be objected to after notification ("objection cartels"), while still others may require prior authorization by the authority ("authorization cartels"). Even after being legalized, notification and objection cartels are subject to controls in case of abuse. The rationale for such exemptions, as stated by the drafters of the Act, is that "competition is not in and of itself the goal, but rather the means for improving efficiency and technical progress...through certain necessary restrictions of competition inherent in rationalization agreements the premise for an increase in efficiency and an improvement in the satisfaction of consumer demands can be set"[31]. Indeed, participants in rationalization agreements must be able to demonstrate that these will enhance technical or economic efficiency and that efficiency gains will be passed on to consumers in the form of lower prices. However, on the basis of an empirical investigation of some legalized rationalization agreements and crisis cartels in Germany, it has been suggested that, while they promote the viability of producers in an industry, there is no compelling evidence that they have greatly increased to productivity and efficiency improvements; on the contrary, the evidence suggests that prices are relatively greater, and output relatively less, as a result of cartelization[32].

43. Rationalization may have some advantage for industries with over-capacity facing long-term structural declines in market demand. In cyclical, capital-intensive industries, they may impose higher prices on consumers in exchange for a lower degree of risk, lower cost of capital and higher profitability for the firms; yet, by raising profitability, they may also make it possible for firms to tolerate higher short-term costs and the long-run maintenance of excess or inefficient capacity. Other types of cartels, particularly those allowing firms to realize economies of scale or supporting the provision of sector-specific public goods, such as product quality standards, may enhance efficiency, allow market entry barriers or enhance competition by SMEs against larger firms. Yet where the size of such cartels, or their activities, exceed what is optimal for efficiency, or where they facilitate collusion in other areas or the foreclosure of potential competition, cartelization may not generate benefits sufficient to offset the harm to competition. Substantial cost savings and the benefits of risk-sharing and complementarity may also result from joint research and development, which may enhance competition by generating new products; however, if industrial policies rely on supra-competitive pricing by the firms involved to encourage innovation and investment by them, they may also inhibit economic activity in downstream markets. Competition authorities in developing and other countries should take into account such factors in assessing the price implications of cartels or joint ventures and in deciding whether to authorise them.

C. Vertical RBPs, dominant positions of market power and prices

44. Among the different types of vertical restraints, resale price maintenance in particular is subject to per se prohibitions in most competition laws. Other vertical practices would normally be evaluated on a case-by-case basis, taking into account any pro-competitive or efficiency

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[31] See Audretsch, D., "Legalized cartels in West Germany", International Institute of Management, Berlin, 1988, p. 3.

[32] Ibid.

benefits. Special exemptions are normally provided in respect of intellectual property rights, although there is some uncertainity as to the circumstances under which the exercise of such rights may be considered to be abusive. Given the concentrated market structures that exist in many developing and other countries, competition authorities have often paid particular attention to the behaviour of market-dominating firms, including pricing by such firms. In some countries, presumptive market shares for establishing dominance have been laid down.

45. In Brazil, controlling distribution and supplies to the detriment of competition, predatory pricing, tying arrangements, "market dominance or partial or total elimination of competition" and "elevating without just cause prices of goods or services" may be "crimes against the economic order"; most of these practices are also controlled under the ordinary competition procedures, as well as other vertical RBPs such as resale price maintenance, price discrimination, restrictions on quantities of goods sold or produced, and limiting or preventing the access of new undertakings to the market[33]. The Brazilian government, with the aim of combating inflation, is now considering the adoption of a new competition law under which "abusively increasing the price of a good or service" would be illegal[34]. Cases have recently been brought against 22 pharmaceutical firms for arbitarily increasing profits by increasing prices by 150 per cent above the rate of inflation over a 30-month period[35].

46. The Polish Antimonopoly Act distinguishes among monopolistic vertical practices (imposing onerous contract terms yielding undue benefits and conditional sales) and monopolistic practices constituting abuses of a dominant position (countering the formation of conditions indispensable for competition, market division, price discrimination, boycotts, resale price maintenance and predatory pricing); both are prohibited unless they are necessary to conduct an economic activity and do not induce a substantial limitation of competition. Certain actions by firms in a monopolistic position or dominant position (the latter presumed where market share exceeds 30 per cent) are also prohibited, including limitations on production, sales or purchase, particularly where they lead to price increases, refraining from sale in order to increase prices, and asking extremely high prices. Where a price increase has resulted from any RBP, the Anti-Monopoly Office may order the price to be lowered, but the Office has been careful about using such powers; recognising that price control would hinder the transition from a command economy to a market one and given difficulties in working out costs of production, or proving monopoly practices, it has reacted only to the most aggressive price behaviour by monopolists[36].

47. Price controls have been imposed in Easten Europe in the context of privatization. In the former Czechoslovakia, the acquisition by a Franco-Swiss consortium of a majority share in a chocolate manufacturing firm with a monopoly position which was being privatized was permitted upon the condition that prices not be raised more than 50 per cent above the cost of supplies

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[33] See Law No. 8137 and Act No. 8158.

[34] See "Brazilian government wants to use antitrust law to combat price gouging", Antitrust and Trade Regulation Report, Vol. 64, No. 1612, p. 503, 29 April 1993.

[35] See "Brazilian government opens probe of drug firms for antitrust violations", Antitrust and Trade Regulation Report, vol. 64, p. 591, 13 May 1993.

[36] See J. Ordover and R. Pittman, "Competition policies for natural monopolies in a developing market economy" (mimeo).

over the following five years[37].

48. The emphasis of developing and other countries on the links between market-dominant enterprises and pricing, has some similarities to the approaches followed in some developed countries. In Germany, for example, tying agreements, refusals to supply and certain discounting practices, normally subjected to case-by-case analysis, are illegal per se when practised by a dominant firm. In some countries, the competition authorities have attempted to remedy abuses of dominant position by imposing or negotiating prices which may be based on prices or profit levels in similar markets which are competitive, or which are related to an index of costs. Such measures, while temporarily useful for checking abuse (particularly in markets for homogeneous products), would run the risk in the long run of deterring new investment or market entry.

49. Similarly, while strong provisions on abuses of dominant position and pricing may be neccessary in the competition laws of developing and other countries, given their market conditions, care would have to be taken to ensure that the implementation of these provisions did not restore price controls in another form. Any pro-competitive effects of vertical restraints, such as the ensuring of quality, safety, adequate distribution or service, should be taken into account.

D. Pricing and natural monopolies

50. The problems of pricing and vertical RBPs are particularly difficult in the case of natural monopolies. Such monopolies exist where the economies of scale make it very difficult or impossible for market entry to take place and a monopoly by a single supplier is the most efficient solution; typically, such natural monopolies include infrastructure or utility industries based upon networks such as electricity, water, gas, roads, railways, harbours and airports. However, a distinction should be made between those core activities of a natural monopolist where such economies of scale really exist and associated activities over which it has acquired a monopoly because of regulatory entry barriers; competition in such associated activities are increasingly being allowed to take place in several countries. Moreover, technological change is reducing the ambit of some natural monopolies, notably in the telecommunications industry.

51. But in many developing and other countries, even where market entry in some areas covered by a natural monopoly's operations might be possible, there may be a shortage of enterprises able and willing to compete in these areas. It would therefore be neccessary for competition authorities to pay particular attention to their behaviour. In addition, ordinary RBP controls by themselves may not suffice to control the behaviour of natural monopolies and a special system of industry regulation may be required to undertake such tasks. Unlike RBP controls, which seek to reduce private obstacles to the operation of market forces, industry regulation seeks to emulate market forces by bringing about the pricing and output effects that would occur if the industry were competitive. The establishment of such regulatory systems, even where desirable in principle, should be subjected to cost-benefit analyses since, as discussed below, regulation of natural monopolies is a complex and resource-intensive exercise.

52. In countries where such regulatory systems have been established, governments have used

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[37] See "Philip Morris deal to test CSFR competition office", Business Eastern Europe, 25 May 1992.

different methods for regulating pricing by natural monopolies, in an attempt to balance the objectives of consumer welfare, efficiency, competition, minimal regulation and cost-effectiveness. But in no other area are the potential conflicts among these objectives so sharp. Ideally, administered pricing for natural monopolies should attempt to simulate the effects of a competitive market, induce both good service and transparent prices which are close to costs, impose a degree of risk and accountability on the firm and on its management for their decisions, maintain a degree of flexibility to meet changing market conditions, provide incentives for cost-cutting by the monopoly and for market entry where possible, and yet provide enough stability to encourage the firm to make the large investments that are often neccessary in such industries. Inevitably, some trade-offs among these objectives have been neccessary.

53. In the United States, the most common method of controlling pricing by natural monopolies is to regulate the profits or the rate of return on assets they are allowed to earn (known as cost-plus pricing). This method has the advantage that the information requirements of the regulator, while substantial, are smaller than when prices are controlled, lessening the need for highly trained staff. However, such profit controls may provide little incentive to reduce inefficiencies and improve technology and may also encourage over-capacity or the provision of unneccessary or costly services. There may also be difficulties and a measure of arbitariness and inconsistency in deciding what should constitute a fair or reasonable return.

54. Regulation by means of "price caps" (also known as "incentive regulation") has now been introduced in the United States in some areas. Similar methods have also been introduced in France to regulate pricing by some natural monopoly PEs. Such "price cap" methods are similar to those used in the United Kingdom where, typically, a ceiling is put on the annual increase over 5 years in the monopoly's prices for individual services or for a basket of services; this ceiling is calculated by subtracting a given number of percentage points from the increase in the Retail Price Index (the RPI-X formula). Although the distinctions between price controls and profit controls for natural monopolies are not clear-cut in practice (since the projected rate of return is an important factor in determining the ceiling), the fact that the price is set for a few years provides the firm with flexibility and the incentive of being able to reduce costs without immediately having to cut prices. However, the successful implementation of price-cap controls depends upon the ability of regulators to obtain accurate information from the regulated company, to assess it and to set appropriate prices for a few years in advance. Since price caps may provide an incentive to diminish service, making it neccessary also to regulate the quality of service. In the United Kingdom, to facilitate the task of price setting, recourse is sometimes made to "yardstick competition", involving the comparison of costs and prices of different regional natural monopolies; in the water industry special merger controls are also applied to ensure that mergers among regional water authorities do not prevent such comparisons.

55. Under both rate of return and price cap systems, regulators have sometimes established prices for some services which are higher than might be justified from the monopoly's own costs (since the monopoly will already have recovered much of its expenditure on capital equipment) in order to provide an incentive for market entry for the supply of these services, or to discourage market exit of existing competitors. As natural monopolies are most common in industries with major distribution networks, to which potential competitors would need to have access, regulators have also had to decide which firms are to be allowed to enter which segments of the market, ensure interconnection with networks is not denied, control the prices and conditions for interconnection and prevent the monopoly from acquiring too much information about its competitors' businesses while providing access. It has also been neccessary to ensure the monopoly is not enabled to undertake predatory pricing by practising discriminatory pricing

and cross-subsidization among different services for different customers, while taking into account the efficiency advantages of cross-subsidization, regulatory obligations upon the monopoly to cross-subsidize less profitable basic services for some customers and the need to prevent collusion between the monopoly and its "competitors". In general, regulators have had to undertake "assymetric regulation" between the monopoly's activities and those of its competitors in order to overcome its inherent advantages. In a sense, therefore, regulators in some countries have been driven towards "managed competition" which will, it is expected, become self-sustaining and give rise to dynamic efficiency gains and lower prices in the long term.

56. Taking into account the paradoxes inherent in such an approach as well as considerations of scale and scope economies, avoidance of over-capacity, incentives for investment and security of supply, difficulties in regulating natural monopolies have been experienced by some developed countries and that there is controversy as to whether and how much competition in some natural monopoly industries is possible and appropriate[38]. The answers to such questions will vary in different industries and countries but it is generally accepted that competition can only be introduced in a phased manner. Given that most developing and other countries have limited effective demand but massive needs for investment in infrastructure, limited resource and administrative skills, a paucity of data on costs (and difficulties in forecasting costs in an environment of deregulation and high inflation), it would certainly not be easy for authorities in many developing and other countries to undertake such complex tasks. Moreover, natural monopolies in developing countries may often be operated by transnational corporations (TNCs) which have the possibility of practising transfer pricing abuses.

57. Some developing and other countries are beginning to adopt regulatory structures similar to those prevailing in developed countries. In Malaysia, for instance, regulatory bodies covering privatised natural monopoly sectors have been established to protect consumer interests while ensuring the creation of healthy competition. Even while the telecommunications monopoly was still a PE, however, it was suggested that there were problems in respect of the resource costs of regulation (an RPI-X formula is used for price-setting), informational assymetry between the firm and its regulator and entry-deterrence behaviour against potential competition in respect of "value-added networks"[39]. Similar regulatory frameworks have been introduced in Argentina. Rate of return regulation has been preferred by Jamaica in the telecommunications sector (see the following chapter).

58. In Poland, the Antimonopoly Office has had to deal with numerous cases of abuses of dominant position by natural monopolists, particularly municipal water, electricity, gas, and sewerage services, as well as telecommunications networks[40]. The Office has undertaken steps to elaborate future legal regulations of such sectors by setting up agencies and training staff. It also has staff on the supervisory level of PE natural monopolies. A new law aiming at breaking the national telecommunications monopoly into small regional companies and encouraging new

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[38] See for example International Energy Agency, "Electricity supply in the OECD", 1992, pp. 46-47.

[39] See C. Adam, W. Cavendish and P. Mistry, "Adjusting privatization", James Currey, London, 1992, pp. 268-269.

[40] See "Annual Report..."op.cit.

entrants has been adopted[41].

59. It has been suggested that one solution for countries with a developing market economy is to adopt a dual structure, controlling pricing by natural monopolies in areas where they are already providing service through rate of return regulation or RBP controls of dominant firms, while allowing them freedom to contract with customers for new services on unregulated prices and terms; price caps might be introduced as economies become more mature and cost and productivity trends in the industries concerned become more predictable[42]. In any event, the solutions chosen will depend upon the specific problems faced by each country. However, technical cooperation from countries having experience in this area would be useful for other countries wishing to regulate competition and/or pricing in different natural monopoly industries in a manner which would be both effective and workable within the limitations of their resources. International comparisons of prices may be a useful guide in this respect. This task may also be facilitated by implementing certain methods for minimizing monopoly structures and powers, as discussed in the following chapter.

60. In most countries, the provision of natural monopoly services has traditionally been the responsibility of the government. However, the problem of pricing by natural monopolies exists even when these are operated by government departments or PEs. Unlike private firms, PEs may sometimes charge prices which are below costs (restraining market entry). Although commercial pricing (often on a cost-plus basis) has now gained favour, it may merely mask operational inefficiencies and monopoly situations[43]. Thus, it is important to establish separate institutional bodies to monitor pricing by PEs; in France, for example, some natural monopolies are regulated under 3-year "contractual plans" dealing with pricing and efficiency and service targets. Nevertheless, where a natural monopoly is privatized, it would usually have a greater incentive to charge high prices than would an PE. The question of privatization of natural monopolies is dealt with in the following chapter.

61. One relevant factor for developing and other countries in deciding upon appropriate regulatory regimes may be their influence upon foreign trade and investment. In Australia, it has been indicated that one main reason why some firms have been granted licences to compete with Telstra, the former state-owned telecommunications monopoly, is to make the industry used to competition in the home market, so it would be better able to compete in the Asian region; conversely, Telstra's decisions as to whether it will proceed in the region by allying with local carriers, by buying stakes in foreign companies, or by competing with them, will greatly depend upon the regulatory stance in different countries[44].

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[41] See "Eastern Europe on the line", The Economist, 8 February 1992.

[42] See Ordover and Pittman, op. cit.

[43] See Trade and Development Report 1992 (UNCTAD/TDR/12), Part Three.

[44] See "Investors move as Asia gets on the phone", Financial Times, 2 June 1993.

Chapter III

COMPETITION, PRIVATIZATION AND DEMONOPOLIZATION

A. Privatization, efficiency and competition

62. For the purposes of this study, the term "privatization" refers to three basic concepts: (a) divestiture, i.e. the partial or total transfer of ownership of a PE or of its assets to the private sector, such as through a public share offering, the distribution of vouchers, the private transfer or offer of shares or assets, staff or management buy-outs, or liquidation of the firm and sale of its assets; (b) the transfer of a degree of control or management of the operation of a PE to the private sector, such as through leases of assets, management contracts, joint ventures or operating concessions; and (c) allowing the private sector to provide services hitherto provided by the State or by municipal authorities, such as by providing concessions or franchises. In practice, the differences among these concepts are not clear-cut, while a mix of methods is often used. Privatization should be distinguished from the establishment of a PE institutionally separate from the government ("corporatization"), the reorganization of a PE along commercial lines to make it more efficient ("commercialization"), or the liberalization of regulatory entry barriers to competition from private firms and/or the breaking-up of the PE into smaller units ("demonopolization"). Nor are the overall process of transforming an economy to operate on market principles or the increase of the role of private enterprise vis-a-vis the public sector considered to be privatization for the purposes of this paper.

63. Privatization has occurred on a massive scale in many countries in recent years[45]. However, for a number of reasons, the privatization process has been difficult and slow in many developing and other countries and divestiture has mostly consisted of selling off profitable SMEs rather than large loss-making firms[46]. But over the last two years, there has been an increase in the pace of sales, in the number of large PEs being sold or readied for sale, and in the number of countries adopting privatization[47]. Yet one key problem, particularly in poorer developing countries and in Eastern European countries, continues to be the mismatch between the large number of PEs to be sold off and the shortage of firms (including foreign investors) which are interested in acquiring a PE, have the financial resources to acquire it and invest in it, and are capable of operating it efficiently[48]. This shortage has been aggravated by macroeconomic difficulties, lack of resources and weak private sectors and capital markets in developing and other countries. Moreover, potential acquirers have not been eager to acquire those loss-making firms requiring large investments which governments wish to dispose of speedily.

64. An important motivation for privatization has been the attainment of greater efficiency. Experience has often shown PEs to be prone to inefficiency because of weak profit incentives,

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[45] See the Concentration study and "Presentation of national experiences with privatization" (UNCTAD/DSD/Misc.9).

[46] See for example UNCTAD/TDR/12 and UNCTAD/TDR/13, op. cit.

[47] See "Privatization: the lessons of experience", World Bank, April 1992.

[48] See report of the Ad Hoc Working Group on Comparative Experiences with Privatization on its first session (TD/B/39(2)/8).

conflicting requirements, interference in management by the Government and "soft" budget constraints. PEs do not run the risk of bankruptcy, a key element of the competitive pressure provided by the market. Moreover, if a Government is simultaneously the owner of a PE, its customer and the regulator of its behaviour in the public interest, the separation of these interests might be blurred; in particular, it may be difficult for governments to avoid treating PEs in a favourable manner or subsidising them, thereby distorting competition. PEs are also likely to be able to bring to bear more effective pressure to maintain protective regulatory entry barriers.

65. Thus, privatization has often been followed by gains in productive efficiency. There is ample evidence of efficiency improvements occurring after privatizations in developed countries, and improvements have also occurred after privatizations in some developing countries such as Jamaica and Malaysia[49]. A World Bank study also found increased returns on sales, assets and equity, heightened "internal" efficiency, improved capital structures and increased capital expenditures subsequent to some privatizations in some developing countries[50].

66. Yet, while there are numerous examples of inefficient PEs in developing countries, this may be due more to general government policies or to the overall economic environment than to deficiencies within the PEs themselves. Since privatization has often been preceded or accompanied by commercialization and/or demonopolization of the firm concerned, as well as by wider economic reforms, it is in practice difficult to be sure which improvements in a firm's performance or in consumer welfare arose solely from privatization. The evidence suggests that PEs in developing or other countries are not necessarily less efficient than private firms in those countries[51]. At the level of the firm, the pressure to become more efficient is created not by private ownership as such, but by greater accountability for poor performance - the accountability of firms to market disciplines and the accountability of managers to owners who are concerned about profits and losses. To the extent, therefore, that the market and/or private owners are unable to provide pressures for accountability which are stronger than those already provided by the Government, privatization may not result in greater efficiency. This may be the case particularly in developing and other countries where competition is often weak, where there is usually no effective threat of takeover to inefficient firms, or where there may be little effective monitoring by shareholders or by creditor financial institutions. However, even if competitive markets are established, they may not necessarily lead to immediate gains in the efficiency of the privatized firms, as indicated by privatization experiences in the insurance sector in some Latin American countries[52].

67. Moreover, there is much less evidence as to improvements in allocative efficiency or cheaper prices for consumers arising after privatization. Even where privatization results in more production efficiency in the privatized firm, it may in fact lead to decreased allocative efficiency because a private firm would tend to have more incentive than a PE to charge higher prices.

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[49] Ibid. See also "Adjusting Privatization", op. cit.

[50] See "Privatization: the lessons of experience", op. cit.

[51] See UNCTAD/TDR/12, op.cit. and H. Cheng and A. Singh, "Public enerprises in developing countries and economic efficiency", UNCTAD Review, No. 4, 1993 (UNCTAD/SGO/7), p. 45.

[52] See "Insurance in developing countries: Privatization of insurance enterprises and liberalization of insurance markets" (UNCTAD/SDD/INS/3).

resulting in a loss for consumers. This problem, which is a possibility in developed countries mainly in respect of natural monopolies, has a much wider significance in developing and other countries, since the often weak competition in their markets would not act as an effective check upon monopoly pricing.

68. It is also significant that most of the countries in respect of which efficiency gains have been found from privatization are developed or middle-income developing countries with relatively large and diversified economies, capital markets and/or available entrepreneurial or managerial skills. Although the results of some privatizations have been positive even in low income countries such as Niger, Mozambique or Swaziland[53], privatizations have been relatively less successful in Kenya, Malawi, Papua New Guinea and Trinidad[54], while in one least developed country, Bangladesh, privatization of PEs in the jute and cotton textile industries resulted in these firms becoming more inefficient[55]. In Chile, which was in the midst of a deep recession and "shock therapy" adjustment in the 1970s, credit constraints and the rapidity and scale of privatizations resulted in sales of PEs to oligopolies with access to the international capital market, leading to increased market concentration; eventually, many of the firms privatized and their acquirers became bankrupt (leading to a financial crash because many of the privatized firms were banks) and the government was compelled to reacquire several privatized firms[56]. But the second wave of Chilean privatizations in the 1980's, which was better prepared and took place in a more favourable economic environment, was successful.

69. Moreover, it is often not only privatized firms which have to learn how to operate efficiently, but existing private firms as well, since these may have been able to buy supplies from PEs at subsidized prices, or may have been favoured in subcontracting arrangements. For this reason, in Mexico, the privatization programme was preceded by removing subsidies on interest rates and production inputs, which led the private sector away from dependence on the public sector[57]. In general, the scope for, and the benefits from, privatization will be the greater the higher the level of development of the private sector and of the economy. But privatization would often be less important than the emergence of new private businesses. In China and the Republic of Korea, for instance, the expansion of PEs has been restrained, while the growth of a dynamic private sector has been encouraged, thus changing the public sector-private sector mix of the economy[58].

70. In this connection, it should be taken into account that there will be competition for scarce resources between privatized firms and budding private firms, so that rapid privatization

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[53] Ibid.

[54] See "Ajusting privatization", op. cit.

[55] See V. Bhaskar, "Privatization in develping countries: theoretical issues and the experience of Bangladesh", UNCTAD Review op. cit., p. 83.

[56] Ibid.

[57] See "Senior officials from Argentina, Chile and Mexico reflect on econmic reform", IMF Survey, 16 March 1992.

[58] See "Privatization: the lessons of experience", op. cit.

might impede potential market entry. In an environment where investment finance is scarce, for instance, divestment of PEs may foreclose such finance, reducing greenfield investment which might have been more productive, as well as increasing competition: this is reported to have happened in Argentina, for instance[59]. Even after privatization, large privatized firms may compete for private sources of credit at the expense of new and small firms. Such problems would be worse where financial institutions being privatized are acquired by industrial firms, providing the latter with subsidies which governments may have stopped. In the Republic of Korea, for instance, banks being privatized were acquired by large conglomerates, which used their resources to buy up other firms being privatized and financially troubled firms, thus enhancing market concentration[60]. However, ceilings are now placed on the ownership of shares in privatized banks. As confirmed by the experiences of Chile and the Republic of Korea, access to finance is a key element in determining whether divestment leads to increased concentration rather than to increased competition (this is not such a constraint where PEs are sold to foreign investors).

71. The goal of privatization should be to increase overall macro-economic efficiency, rather than just the performance of the privatized firms. Ownership, competition and regulation are interrelated elements and the efficiency implications of a change in one of these elements will, as a rule, be inflenced by what happens to the other two. The efficiency implications of privatization depend very much on the competitive and regulatory environment in which economic agents operate. This environment typically has substantially larger effects on performance than ownership per se, but if properly implemented, privatization would be a key element in the long-term creation of such an environment. For the purpose of improving economic efficiency, therefore, the design and implementation of privatization programmes should not be undertaken in isolation from the overall context of economic reform and the creation of an environment conducive to the development of a competitive private sector. The experiences of Chile and Mexico, for instance, confirm that privatization works best as part of a larger programme of reforms[61].

72. Although the promotion of competition has been one of the explicit or implicit objectives of privatization, it has often not been assigned much weight in practice in many developing and other countries: concentrated market structures have often been maintained or even strengthened, particularly where the privatized firms are large and have strong market positions[62]. It is seldom that specific evaluation procedures or measures have been implemented to verify that public monopolies are not merely being transformed into private monopolies. Even where developing countries have competition authorities, these authorities are sometimes not provided with the mandate to screen the privatization process, or even to consult with the privatization authorities. This may be because it has been assumed that the combination of privatization and the reduction of regulatory entry barriers, as well as the general process of

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[59] See "Argentina survey", Financial Times, 14 May 1992.

[60] Paper by Linsu Kim, "The evolution of public policies and private sector responses in science and technology in Korea" (mimeo).

[61] See "Privatization: the lessons of experience", op. cit.

[62] See O. Bouin and Ch.-A. Michalet, "Rebalancing the public and private sectors: developing experience", OECD, Paris, 1991.

economic reform, would suffice to ensure that competitive market forces develop. There may also be a reluctance to break up large PEs being privatized because it might make their sale more difficult or decrease their sale price, their willingness to invest or their efficiency. In any event, given the concentrated nature of the economies of developing and other countries and the shortage of buyers, the only available and capable buyers might already be holding dominant market positions.

73. Economies of scale and sunk costs of PEs, shortages of managerial resources, or the attitudes of buyers, do sometimes place limits on the degree of deconcentration and demonopolization that can be implemented at acceptable financial or efficiency losses. In Hungary, for instance, a group of farmers expressed the intention to contest the sale of a PE producer of oilseeds to an Italian firm, on the grounds that the privatization provided the firm with monopsony and monopoly powers. However, the director of the competition authority noted that, given the small size of the Hungarian market, it made no economic sense to break up the firm before privatization[63]. In Poland, it is reported that attempts to break up large firms to be privatized have discouraged investors interested in acquiring large market shares[64]. Demonopolization may be particularly difficult in formerly centrally-planned economy countries, since some monopolies may be single factories, or since vertical integration may be important for ensuring continuity of supplies. In any event, it may be less important to break up firms producing goods in the traded sector which are subject to international competitive pressure.

74. The issue of demonopolization is also closely connected to the question of corporate governance. One method of ensuring that privatized firms are controlled by those who are best fitted to do so would be to ensure, as in the French privatizations, that there is a "hard core" of investors (whether local or foreign) who own controlling shares. Where there is a shortage of interested and competent buyers, however, it may be necessary, in the interests of forming such a "core" of owners, to allow concentrated market and ownership structures (particularly interlocking shareholdings and directorships). Another alternative system of corporate governance (although this may be less feasible in the circumstances of many developing and other countries) would be to rely upon supervision by banks, even though this carries risks of monopolisation of financial resources. However, the gift or sale of PEs to large numbers of people through voucher privatizations (and, to a lesser extent, public share offerings), raises questions relating to the effectiveness of such methods for ensuring governance and accountability. The solution which has been adopted in some Eastern European countries, whereby investment trusts are allowed to hold vouchers on behalf of the population, also raises questions as to the accountability of these trusts in respect of their control of the privatized firms, possibilities for collusion and the danger that eventual extensive voucher sales at cheap prices may reinforce market concentration.

75. However, breaking up PEs being privatized or modifying some modalities of privatization may sometimes result in substantial gains for both competition and efficiency. As discussed in the Concentration study, large firm size does not necessarily equate with greater efficiency and may indeed be associated with significant efficiency losses. In countries with shortages of capital or entrepreneurs, it is also not guaranteed that new market entry will eventually palliate the effects of failing to create a competitive industry; even if it does, this may well be at the cost of

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[63] See "Sale of Hungarian firm to foreign buyer will be challenged on competition grounds", Antitrust and Trade Regulation Report, 11 March 1993, vol. 64, p. 274.

[64] See "Investors see a new star rising slowly in the east", Financial Times, 5 January 1993.

over-capacity in industrial plant and higher prices. Moreover, privatized firms may retain dominant market power because of established product names, financial strength (enabling predatory behaviour) or vertical integration. In such circumstances, competition authorities would need to pay particular attention to abuses of dominant position by the privatized firm. Even where the firm is split up prior to privatization, competition authorities may need to pay attention to mergers or collusion among the separated firms.

76. Competition problems may be made worse by the fact that acquirers have often obtained reduced prices, incentives, subsidies or regulatory protection (including through debt-equity swaps) from governments as a condition for the purchase of a PE. In Mexico, for instance, when a telecommunications firm (in which core equity stakes were sold to United States and French telecommunications firms, as well as to a local group) was privatized, it was granted a 6-year monopoly, in return for large investments[65]. In Jamaica, when the PE telecommunication monopoly was sold to a British firm, the monopoly was granted an exclusive 25-year licence for both domestic and international services (renewable for 25 years) and the right to charge rates sufficient to give it post-tax earnings of at least 17.5 per cent[66]. In the automobile and telecommunications sectors in some Eastern European countries, foreign investors which have taken over PEs being privatized have pressed (sometimes successfully) for higher tariffs, import quotas, or public procurement exclusivity.[67] Subsidies or protection may be unavoidable in some circumstances, but should be screened by a competition authority to try and keep dangers for competition to a minimum. Thus, in the former Czechoslovakia, an agreement between the government and a joint venture composed of the national telecommunications authority and two United States telecommunications firms, granting the venture a 20-year monopoly on cellular telephone services and a 10-year non-exclusive licence on data services, was approved by the competition authority because of the large investments necessary; however, the authority refused to approve the grant of exclusive marketing rights for these services to the venture because of the danger to future competition[68]. The question of subsidies or protection to foreign investors is further dealt with in the following chapter.

B. The pace and modalities of privatization or PE reform

77. In general, attempts to force the pace of privatization programmes, without taking into account the structural constraints and absorptive capacity of the economy, may be counter-productive, particularly if privatization takes place in the difficult economic circumstances of stabilization and structural adjustment programmes. In particular, excessive specificity in adjustment programmes on targets and deadlines for divestiture has led to poor results, prompting hasty sales on unfavourable terms[69]. Although the implementation of divestments on

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[65] See World Investment Report, 1992. "Transnational corporations as engines of growth", United Nations Sales publication No. E.92.II.A.19, p. 89.

[66] See "Adjusting privatization", op. cit., pp. 142-147.

[67] See "Free trade and foreign investment in Central Europe", East West (Fortnightly Bulletin), 15 July 1991, and "West hides behind Polish tariffs", Financial Times, 10 March 1992.

[68] See "CSFR: Eurotel wins a little, loses a little", Business Eastern Europe, 27 July 1992.

[69] See "Privatization: the lessons of experience", op. cit.

a large scale may be more feasible after adjustment has occurred, selective and well-prepared divestments, particularly of small PEs and/or PEs already operating in competitive markets, might be undertaken more quickly. These considerations might not apply to the same extent in developing and other countries which are in a relatively better economic condition, which might be able to proceed rather faster with divestment.

78. For countries with less resources, however (and sometimes even for more prosperous countries), other forms of privatization may often be easier to undertake, produce more efficiency gains and pose less risks for competition. Joint ventures, management contracts, leases and concessions have been widely used, but there is scope for their greater use in developing and other countries. But these methods are not a panacea; they may also give rise to different problems for competition and efficiency. Leases, franchises or operating concessions (contracting out), for instance, would allow competitive tenders to be used and service standards to be specified by the government. The time-limited nature of contracting out would also limit risks for competition structures.. But the success of contracting out would depend inter alia upon whether there is sufficient competition for the contract and whether governments are able to ensure that the bidding process involves no collusion or exclusionary behaviour directed against potential market entrants. Competition controls on anti-competitive conduct (and price controls for natural monopolies) would also still be neccessary after the contract is awarded.

79. In the short term, corporatization, commercialization and demonopolization of PEs, combined with broader economic reforms (including encouragement of the private sector), would often be more feasible and fruitful than privatization[70]. A less hasty approach towards privatization would allow enterprises a greater opportunity to increase their efficiency. It would also provide governments with the chance to gain experience in implementing effective competition policies (which should cover PE behaviour) or controls upon pricing by natural monopolies, to make market analyses and to design appropriate privatization methods. In Poland, for instance, market analyses and studies on the prospects for particular industrial sectors are carried out to help choose the method and strategy for privatization and implement foreign investment policy[71].

80. In particular, it may well be advisable for countries lacking the expertise neccessary to regulate natural monopolies to keep them in the public sector unless they need investment which the government is unable to provide (which would often be the case). Where natural monopolies are privatized, contracting out may be a particularly appropriate method, as well as "incremental privatization" (mentioned in the previous chapter), whereby private sector entry and a competitive market is permitted for new services or services extended to new geographical areas. This is increasingly occurring in respect of new services in the global telecommunications industry, for instance, as well as in the electricity generation industry in Asia and in Eastern Europe[72], often using "build-own-operate" or "build-operate-transfer" methods[73]. However,

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[70] For the experiences of China in this respect, see UNCTAD/TDR/13, op. cit., p. 140.

[71] See "Privatization in Poland", Information Centre, Ministry of Privatization, October 1992.

[72] See "World electricity", Financial Times, 14 December 1992.

such methods would still require well-conceived and effectively implemented regulation. Competition and regulation might be facilitated to some extent by breaking up a large national monopoly into smaller regional monopolies (allowing competition in the border sectors of regional monopoly areas and comparisons among prices charged), as well as by breaking up vertical linkages to separate natural monopoly elements from potentially competitive activities (thus, electricity generation, transmission and distribution might be separated). Both these methods have been used in Argentina and the United Kingdom upon privatization of some PEs (although competition in the border sectors of regional monopoly areas has not so far been allowed), but they might well be used before privatization.

81. In practice, given the huge number of PEs in developing and other countries and the difficulties and slowness of the privatization process, their commercialization has usually taken priority over privatization[74]. Demonopolization, while less common, is also being implemented. In China, for instance, evidence of profit declines in sectors where the monopoly power of PEs was eliminated and non-PEs have entered in large numbers suggests that there has been increased competition in these sectors; profits have not declined in some sectors with continuing PE monopoly power.[75] In the Philippines, potential competitors to the telecommunications monopoly have so far been deterred by the monopoly's resistance to interconnection with its network, but the government has expressed determination to allow such interconnection[76]. Some countries have also applied their competition laws to control the behaviour of PE monopolies; in Chile, for instance, cases were brought against the State-owned telephone company (which has since been privatised) for obstructing interconnection by private firms[77]. However, it may sometimes be necessary to demonopolise in a phased manner to allow PEs some opportunity to prepare to withstand the full force of competition.

82. However, where commercialization or demonopolization are planned by policy-makers as intermediate steps towards privatization, it may be difficult to maximise PEs' efficiency because of lack of motivation in workers and management who know privatization is the ultimate objective. It may also be difficult to undertake extensive reforms whose costs may not be recouped in the sale price for the PE, particularly as a purchaser may prefer to reform the firm in a different manner. In several developing countries, PE reform under structural adjustment programmes has frequently failed to achieve the results sought, while improved financial performance has been due more to monopoly price increases than to better management[78]. It is because of such reasons, as well as because of the difficulties and slowness of the privatization

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[73] Under these methods, private firms construct infrastructural facility using their own funds, operate them and either own them outright or have to transfer them to the government at the end of the concession period.

[74] See UNCTAD/TDR/12, op. cit.

[75] See World Economic Survey, United Nations publication (E/1993/60), pp. 197-198.

[76] See "Ramos ends telecoms monopoly", Finacial Times, 26 January 1993.

[77] See "Handbook on restrictive business practices legislation" (TD/B/RBP/49).

[78] See TDR 1992, op. cit.

process and the need to build up the private sector and a market economy, that some countries in Eastern Europe have preferred to undertake privatization in a rapid manner, often by distributing free vouchers among the population. Although such speed may be justified in the specific circumstances of individual countries, it remains true that hasty privatisation contains dangers for competition, as evidenced by the Chilean experiences described above. The successes of Poland in improving the efficiency of PEs (referred to in Chapter I) indicate that much can be done in this respect, particularly if the overall economic environment is reformed. But where loss-making PEs are unlikely to be viable even in the long term, it may be appropriate for them to be liquidated and their assets sold off to private firms, as has happened to a large extent in Poland[79].

[79] See "Privatization in Poland", Information Centre, Ministry of Privatization, October 1992.

Chapter IV
COMPETITION POLICY AND TRADE AND FOREIGN INVESTMENT LIBERALIZATION

A. Effects of foreign direct investment upon competition

83. Extensive liberalization of foreign investment regimes has taken place in developing and other countries in recent years. Such liberalization (as well as liberalization of other regulatory barriers and privatization) has contributed to the increased amount of foreign investment received by some of these countries, although many countries which have liberalised have failed to obtain any significant increases in investment inflows. Foreign investment directed towards production for export markets would not affect competition within domestic markets for final products. Where the investment is directed towards domestic markets, however, it would have usually extensive effects upon competition since the average size of foreign affiliates of TNCs in developing countries larger than that of their indigenous competitors[80]. TNC affiliates are also often wealthier, more efficient or more profitable. They tend to operate in relatively globalized manufacturing industries requiring extensive technology, capital and marketing skills, in vertically-integrated resource-based industries (to a decreased extent) and in key service sectors. Even where national firms have a similar size or degree of diversification as TNC affiliates, or have acquired comparable skills, these affiliates would still often be more competitive by virtue of the fact that they are part of a large international entity; TNCs tend to be more vertically integrated than purely national firms and often conclude exclusive dealing arrangements with their suppliers and/or consumers[81]. However, local firms in developing countries are sometimes as (or even more) efficient than TNC affiliates, in part because of greater local knowledge and freedom as to sources of technology and production inputs.

84. The initial market entry by foreign investors has often reduced industrial concentration and increased competition, leading to lower prices by incumbent firms (which may comprise both local firms and other foreign-owned firms). This would be the case particularly if the investor's competitors respond to the presence of the new market entrant by improving their own efficiency. The higher the barriers to market entry and the more entrenched the incumbents, the greater may be the potential usefulness of foreign investors as an "instrument of competition", due to their ability to surmount such barriers. Particularly in markets in which TNCs are dominant, entry of a newcomer TNC with similar competitive advantages may be the most effective means of stimulating competition. This increased competition may continue, or it may be adversely affected by market exit by some incumbent firms, specialisation or collusion among producers, or market dominance by the investor.

85. Much will depend upon the mode of entry by the investor and upon industry- and country-specific circumstances. Where entry is through greenfield investment and the subsidiary is not introducing a new product into the economy, the concentration ratio should fall and competition increase, at least in the short term. Where the investment takes place through the take-over of a

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[80] See J. Dunning, "Multinational enterprises and the global economy", Addison-Wesley, Wokingham, England, 1993, p. 422-434 and World Investment Report, op. cit., pp. 122-124.

[81] Ibid.

local firm, or a joint venture with it, there may be no immediate effect on the concentration ratio; indeed, take-overs or joint ventures may strengthen concentration where the TNC (through imports) and the local firm had been competing (or would have competed) in the same sector, or where the firm taken over would otherwise have been a strong competitor to the foreign investor. But take-overs may be followed by increased competition because of the emergence of a stronger competitor.

86. If the market presented ex ante competitive characteristics, entry by a TNC with better access to specialized and scarce resources could lower the degree of rivalry. Foreign investors would be more likely to drive out local competitors if the latter are inefficient or if the market is small. In Kenya, for instance, the entry of foreign firms weakened the competitive position of domestic market incumbents.[82] But even if higher concentration leads to decreased competition (which is not neccessarily the case), the net effect might still be welfare-improving if efficiency gains outweighed the loss from monopolistic behaviour, particularly if the resources which are freed are employed more effectively elsewhere (which did not happen in Kenya). Moreover, as discussed in the Concentration study, the impact of market entry by a foreign investor is often circumscribed by the emergence of a dual market structure, with an oligopoly of TNCs focusing upon higher value added market segments and local firms catering for less profitable segments requiring less skills.

87. However, having entered into new markets, foreign investors may create their own barriers to potential competition or drive competitors out from the market through the use of RBPs rather than through greater efficiency. The structure of a TNC would allow it to pursue distinctive patterns of behaviour, including discriminatory pricing involving transfer pricing abuses, or cross-border subsidization of predatory pricing or non-price competition. In the Latin American electrical equipment industry, for example, there is evidence of cross-subsidization, control of supply channels, formal and informal collusion, interlocking directorates, predatory pricing and anti-competitive mergers among and by TNCs[83]. In Hungary, TNCs have invested in local manufacture in order to preempt the entry of competing TNCs, particularly as the market can sustain only a few enterprises[84].

88. In general, there are positive correlations between the foreign-owned share of developing country industries and indices of market concentration[85]. It is not clear to what extent this is because TNCs have a role in increasing concentration (there is evidence of this in a few cases) and to what extent it is because TNCs are attracted to markets where entry barriers or economies of scale allow them to earn above-average returns (TNCs tend to operate within oligopolistic structures in their home economies as well). It would appear natural that TNCs are attracted to concentrated markets, since their specific advantage vis-à-vis national firms in developing and other countries lies in the posession of scarce managerial, technological, financial

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[82] See World Investment Report, op. cit., p. 124.

[83] See "Multinational enterprises enterprises and the global economy", op. cit.

[84] See Marton, K., "Foreign direct investment in Hungary", Transnational Corporations, vol. 2, no. 1 (February 1993), pp. 111-134.

[85] See "Multinational enterprises and the global economy", op. cit. and World Investment Report, op. cit.

and organizational endowments. There is evidence that TNCs tend to concentrate in sectors most subject to economies of plant or firm size and economies of scope, as well as in knowledge-intensive industries[86]. But concentration is not invariably associated with the presence of TNCs, particularly where their main competitors are other TNC affiliates: a study of the pharmaceutical industry in Brazil found no such association even though the industry was almost completely dominated by foreign-owned firms[87].

B. Competition policy and foreign investors

89. For the purpose of controlling RBPs by foreign investors, no special provisions are needed in competition laws. The application of competition laws to the behaviour of foreign investors should be in conformity with the national treatment principle laid down by the RBPs Set (para. E.3). There is no evidence that foreign investors practise RBPs any more often than domestic firms. However, since they may be able to acquire strong market power and since the global orientation would enable TNC affiliates to engage in practices different from those used by independent firms, their behaviour is likely to require scrutiny by competition authorities. But TNCs may regard some practices (such as tied purchases) as a legitimate part of their global competitive strategies and might therefore react to the possibilities of investigation by reducing or restricting their investments. Moreover, in examining whether acts or behaviour between TNC parents and affiliates, not having restrictive effects outside the related enterprises, are abusive or not, it would also be necessary, as provided for by the Set, to consider whether these are appropriate in the light of the relationship between the enterprises concerned. In practice, it may be difficult to assess the appropriate scope of exemptions in this respect, given the increasing diversity of non-traditional forms of investment used by TNCs. In Spain, a British chemicals firm is being investigated in respect of price increases for products it sells to a joint venture it has established with a Spanish firm, allegedly aimed at depressing the profits of the venture[88].

90. However, foreign investors would usually have no objection to being subject to competition rules if these are applied in a speedy and flexible manner which fully takes into account efficiency considerations. They may also welcome the application of competition rules against RBPs by their competitors. RBP controls should check anti-competitive behaviour by incumbent firms in reaction to market entry by the foreign investor, although it may be necessary to exercise leniency in respect of mergers or joint ventures between incumbents (or with the foreign investor) where these may make them more efficient. Even for TNCs operating in oligopolistic markets, a major source of uncertainity remains from their being exposed to competition (including predatory competition) from their rivals within the oligopoly. Controls upon abuses by some firms with global market power may in fact encourage specialization by other large firms, leading to greater economic efficiency; one reason why some American electronics firms have chosen to manufacture a considerable part of their production inputs within their own transnational networks, rather than to rely upon independent suppliers, has been the fear that predatory rivals might withold from them the most advanced versions of those

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[86] Ibid.

[87] See R. Jenkins, Transnational corporations and industrial transformation in Latin America, Macmillan, London, 1984.

[88] See "ICI faces anti-trust inquiry", Financial Times, 19 November 1992.

components while incorporating them in their own products.[89] The adoption of competition laws in a growing number of countries and a degree of convergence in national competition regimes would also promote security and stability for TNCs (as well as reducing risks of countries attempting to attract foreign investors through the non-adoption or weak or uneven application of competition policies).

91. But to the extent that concentration arises because foreign investors have been attracted to industries with entry barriers, efforts to lower such barriers may be the best means to promote market entry by both domestic and foreign entry, thus maximising the welfare gains from the presence of the foreign investors. And to the extent that RBPs practised by firms are sometimes in response to entry barriers created by governments, it would be better to modify government policies so they no longer had the incentive or the possibility to engage in such RBPs. The fact that RBP controls are available as a safeguard may alleviate concerns as to possible abusive behaviour by foreign investors and should thus assist competition authorities when they advocate liberalization of foreign investment regimes. Towards this end, competition authorities might undertake market analyses as inputs for the decision as to whether, when and upon what terms liberalization should take place in a given sector.

92. In implementing the reform process in developing and other countries, it would be preferable to liberalize import trade before, or at the same time as, liberalizing foreign investment controls, so that foreign investment is not attracted to protected sectors. However, as noted in the previous chapter, potential foreign investors have sometimes pressed for special protection (including exemptions from competition law) as a pre-condition for investing. In Kenya, for instance, some TNCs have demanded virtually exclusive rights before investing, while proceedings against firms suspected of engaging in RBPs have been hampered by threats of relocation[90]. In Egypt, it is reported that foreign firms demanded protection against allegedly dumped imports from Japan as a price for staying in the country[91]. Such demands should be resisted as far as possible since they may make foreign investment a liability rather than an asset for competition. But where unavoidable, protection should be limited, temporary and conditional upon increases in efficiency.

93. Foreign investors are also often granted investment incentives or subsidies; these may be difficult to avoid in the current climate of competition among governments for foreign investment. However, some flexibility may be neccessary in the application of competition policy in this area, particularly as subsidies or incentive systems, by attracting new economic agents, may make markets denser and more competitive, at least in the short term. Over time, however, entry-inducing rents are appropriated by the new incumbents, partly because incentives are often denied to other potential investors out of concerns about excess capacity, destabilization of markets and misallocation of resources. Incentives should, where possible, be limited, temporary,

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[89] See Vernon R., "Transnational corporations: Where are they coming from, where are they headed?", Transnational Corporations, Vol. 1, No. 2 (August 1992), p. 7.

[90] See report of the Intergovernmental Group of Experts on Restrictive Business Practices on its tenth session (TD/B/1310).

[91] See J.M. Stopford et al, "Rival states, rival firms - competition for world market shares", Cambridge University Press, Cambridge, 1991, p. 219.

conditional upon performance and applied on the basis of national treatment, avoiding putting national firms at a disadvantage. Competition authorities might assist in designing appropriate policies in this area, but some consultations and co-ordination among governments may also be useful, to set some international limits on the use of incentives.

94. Governments need to take fully into account the repercussions for competition in granting (or refusing) incentives, subsidies or special protection; for this purpose, prior consultations among the competent national authorities would be preferable to ex post facto intervention by the competition authority against agreements concluded by another government body. When a German car firm undertook a joint venture with a PE having a dominant position in the car market of the former Czechoslovakia, the venture was promised, in return for heavy investments by the German firm, the maintenance of tariffs against car imports for some years, non-tariff barriers, various subsidies and privileges and exemption from some provisions of the competition law; a controversy subsequently arose when the competition authority protested against the alleged failure to apply to it for approval of the venture, as well as against a sharp price rise and shortages of cars[92].

C. Effects of trade upon competition

95. Competition from imports is a key element in ensuring that a national market remains competitive. Tariffs, quantitative restraints (QRs), subsidies to national producers and countervailing and anti-dumping duties against imports all reduce current competition and future market entry by foreign producers and contribute to the exercise of market power by locally-based producers (which may include foreign-owned firms) to the detriment of local consumers. In particular, QRs, if used in a generalized and permanent manner, may cause greater harm to competition than the equivalent tariff restraint by preventing foreign suppliers from expanding output in an import market in response to collusive pricing by domestic producers. On the other hand, premature exposure of local firms to competition from imports may decimate infant industries and lead to concentration of market power in foreign exporters or in trading intermediaries. But the efficiency and competitiveness of local producers would be undermined if the "infant industry" protection they are granted is inappropriate or over-lengthy, shielding them from the discipline of international competition and encouraging misallocation of resources to sectors which are uncompetitive. Thus, vigorous enforcement of competition laws is particularly important in countries where barriers to imports are high.

96. However, even where such barriers have been liberalized, as in many developing and other countries, imports may have limitations as a source of competition, for example where: imported products do not directly compete with locally-made products because of product differentiation; competition among foreign suppliers, is weak, enabling high prices or RBPs; intellectual property rights restrict parallel imports or competing technologies; and, most importantly for developing and other countries, there are shortages of foreign exchange. In Chile, for instance, extensive, indiscriminate and sudden import liberalization in the 1970s did succeed to some extent in

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[92] See OECD, "Methods of privatising large enterprises", Paris, 1993 and "Czech, Slovak, federal officials examine impact of Skoda/VW venture", Antitrust & Trade Regulation Report, 19 March 1992, p. 364.

putting a ceiling on domestic prices and in increasing the efficiency of those firms which survived[93]. However, in many cases, price decreases were not substantial, because competition among foreign suppliers was based on product differentiation rather than on price and because many of those local firms which did not go bankrupt either merged or, because they controlled distribution channels, began to import "competing" products. National production became exposed to wide fluctuations in international prices for some products and to dumping. More pragmatic policies adopted in the 1980's proved more fruitful.

D. Competition policy and import trade

97. In applying RBP controls, therefore, it is important that competition authorities neither under-estimate nor over-estimate the contribution of imports to competition in analysing market power. For example, mergers or joint ventures among large local firms might not be anti-competitive if the extent of market penetration by imports is taken into account, although difficulties may arise as to how to measure potential market entry by imports. But even where actual and potential imports are fully taken into account, competition authorities should not assume that the presence on the market of imported products will automatically ensure competitive conduct by market participants and should take measures against RBPs which reduce the beneficial effects of trade liberalization. In Poland, for instance, an exclusive distribution contract between a German car producer and a Polish dealer was cancelled as it was considered to constitute a "monopoly practice"[94].

98. Some sectors or areas to which Governments might need to pay particular attention include trading intermediaries, transportation, distribution and some agricultural commodity and high-technology products, as discussed in the Concentration study. In recent cases, for example, the European Commission took action against 15 European shipping firms for operating cartels and market-sharing arrangements on routes between France and some West and Central African countries, as well as against 11 "shipowners' committees" and four liner conferences for abuse of dominant positions to eliminate competitors on the shipping trade between Northern Europe and Zaire[95].

99. Special difficulties may be experienced where competition regimes overlap with intellectual property regimes. In Kenya, for instance, a distributor was prevented from importing a branded pharmaceutical due to territorial restriction imposed by a British patentee on a United States licensee from whom the distributor had bought the product[96]. In recent years, there were tying clauses in 5 per cent of technology import contracts by Nigerian firms (prior to

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[93] See Trade liberalization in Chile: experiences and prospects, UN Sales publication No. E.91.II.D.18, 1992.

[94] See Canadian Competition Policy Record, Vol. N3, No. 4, Dec. 1992, pp. 21-22.

[95] See " ECU 15 million in fines are imposed on shipping firms", Antitrust & Trade Regulation Report, 2 April 1992, p. 422, and "EC C ommission fines shipping conference for practices breaching Articles 85 and 86", ibid., 14 January 1993, vol. 64, p. 31.

[96] Beecham Group v/s International Products Ltd., quoted in D. Gladwell, "The exhaustion of intellectual property rights" (1986), 12 European Intellectual Propety Review, p. 368.

intervention by the authorities)[97] and in 8 per cent of purchasing contracts for machinery and raw materials by Thai firms[98]. Other clauses in 1546 import contracts dealt with by the competition authority of the Republic of Korea between 1981 and 1989 (the majority comprising technology licences) included restrictions on raw materials and parts, restrictions on marketing channels and methods, sales quantities and prices, restrictions on handling competing products or technologies and restrictions on utilizing transferred technologies after the expiration of the contract[99]. As developing and other countries strengthen protection of intellectual property rights, they would also need clearer rules to prevent the exercise of these rights from becoming the basis for abuse of market power, but efficiency considerations and the risk of deterring foreign suppliers would need to be taken into account.

100. Difficulties may also arise where trade regimes attempt to deal with allegedly unfair practices by foreign exporters, such as "dumping" (discriminatory pricing combined with predatory pricing), which may sometimes be combined with subsidised prices, particularly for some agricultural products. Most competition laws would not proscribe agressive pricing practices unless there exists a substantial risk that alleged predators could strengthen market power, affecting competition rather than individual competitors. Using competition law to deal with such practices by foreign exporters would therefore strike the right balance between maintaining the benefits of trade liberalization while dealing with anti-competitive trade practices: in Brazil, for instance, "importing or exporting goods or marketing them below the price charged in the exporting country to the detriment of a competitor based in Brazil" is considered to be a RBP only if it is aimed at, or produces the effect of, dominating the market[100]. However, some developing and other countries are instead starting to apply trade rules relating to anti-dumping and subidies in this area, following the practice prevailing in developed countries. As in some cases in developed countries (see the Concentration study), developing and other countries may also be compelled to tolerate import cartels where these are formed to counteract the market power of foreign exporters, while voluntary export restraints imposed by trading partners would often induce the formation of export cartels which may have "spill-over" effects upon the domestic market.

101. Developing and other countries applying their competition laws to RBPs affecting their import trade will sometimes experience the need to have recourse to extraterritorial exercises of jurisdiction to obtain information or to enforce decisions. In general, they would have sufficient jurisdiction in this area if they modeled the extraterritorial reach of their legislation on that asserted by developed countries, although there are some controversial issues in this area regarding which they would need to choose their own solutions (see the Concentration study). The competition laws of several Eastern European countries already follow the EEC approach in this respect. Whatever the theoretical scope of the jurisdiction claimed, however, it may be difficult in practice for competition authorities in developing and other countries to enforce such jurisdiction. A country victimized by off-shore price fixing, bid-rigging or predatory pricing, for

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[97] See "The relevance of recent developments in the area of technology to the negotiations on the draft international code of conduct on the transfer of technology" (TD/CODE TOT/55).

[98] See "Multinational enterprises and the global economy", op. cit., p. 439.

[99] See "Corporate policies in the Republic of Korea", op. cit.

[100] See Act No. 8158, Art. 3 (xiv).

instance, may be unable (even if it manages to acquire information about these RBPs) to assert personal jurisdiction over the firms concerned; there may not even be jurisdiction over the relevant goods, which may be in the hands of innocent purchasers when they reach the affected country. Where an overseas merger might have anti/competitive effects on the domestic market, a competition authority would usually be able to intervene effectively only if the firms concerned had local subsidiaries; even if this were the case, its actions would be unlikely to have much impact if the main production facilities of the firms were located overseas. It may be recalled in this connection that the RBPs Set (para. E.4) provides that States should seek appropriate remedial or preventive measures against RBPs within their competence when it comes to their attention that such RBPs adversely affect international trade, particularly the trade and development of developing countries.

102. In exercising their advocacy functions in this area, competition authorities might identify sectors for which trade liberalization would be appropriate to improve competition (the powers of the Sri Lankan authority in this respect have been described in chapter 2), where trade liberalization has not had sufficient impact and needs to be supplemented by trade promotion measures, or where internal regulations (such as in the areas of distribution or product standards) are reducing competition from imports. They might also argue, where appropriate, against increased trade protection; such a function is performed by competition authorities in some countries, although sometimes with limited success. In Poland, for example, the Antimonopoly Office demanded a comprehensive evaluation of the consequences of abandoning liberal trade policy and urged that there should be an explanation of the specific reasons for the adoption of protectionist measures and that the scope of such protection should be limited and its duration and the annual rate of its reduction should be specified in advance[101]. However, because of the assymetry of response by trading partners to its earlier extensive trade liberalization, Poland introduced a new and higher tariff structure in August 1991, including higher tariffs for products which the Office had identified with non/competitive domestic markets[102].

103. In practice, therefore, for competition authorities to increase their effectiveness in advocating reduced protectionism, it would be essential to have a supportive international environment where a liberal and pro-competitive trade regime is also maintained by trading partners. It may also be difficult to advocate trade liberalization unless competition authorities can induce confidence in their ability to take action against any anti-competitive practices by foreign exporters. However, the enforcement difficulties in this area would need to be met by strengthened consultations and cooperation among competition authorities, as discussed below.

E. International cooperation

104. The trend towards trade and foreign investment liberalization in developing and other countries, as well as the globalization of international markets and increased international competition in many sectors, should make the task of competition authorities easier in general. Nevertheless, there may be adverse effects for competition in some areas if these same tendencies have the effect of reinforcing the market power of an oligopoly of large firms. In this

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[101] See "Annual Report of the Antimonopoly Office 1992".

[102] See "OECD economic surveys - Poland", OECD, Paris, 1992.

situation, efforts at the national level by developing and other countries to enforce competition laws against possible abuses of market power, while necessary, may not be sufficient. Particular problems may be experienced as a result of market concentration at the global level and the transnational strategic alliances which exist in some sectors (such as the aerospace, telecommunications digital switches, microprocessor or electronic components industries) where barriers to entry are high and technological change is rapid and costly[103], enabling the creation of "technological cartels"[104]. Such concentration or alliances may be necessary to undertake the huge investments required in such sectors and may not necessarily lead to decreased competition in the long term, particularly since the alliances may often be temporary and technologies may change rapidly. But, as discussed in the Concentration study, competition among oligopolists in such sectors would not necessarily extend to all product or geographical markets, nor may it involve competition based on prices. There is therefore a risk of abuses, particularly in the markets of some small economies which may not attract some of the firms in the global oligopoly.

105. It would be difficult for individual competition authorities, particularly those of developing and other countries, to ensure that such firms are accountable for any abuses of market power. National competition policies generally balance the costs and benefits of potentially anticompetitive conduct only at the national level and can protect and promote competition within countries. However, there is also a need to protect the vitality of competition at the global level, to the benefit of all countries and in a manner which would support the economic reform efforts of developing and other countries. Even if all countries were to implement active and effective competition policies in accordance with national considerations, they would not necessarily be able to address conduct or market structure harming competition and efficiency at the global level. Increased international production implies that competitive conditions in one market increasingly determine the activities of a TNC in other countries, as the operations of all affiliates are potentially affected. Moreover, with increased specialization and intra-industry trade, each country more often finds itself in the position of a consumer. Less stringent competition enforcement in some countries may impede market access to foreign firms or provide an unfair advantage to firms from these countries when competing in international trade. Competition policy may also discriminate against firms based in other countries. There may be occasions when there are extraterritorial and/or concurrent exercises of jurisdiction by competition authorities or when the competition policy of one country clashes with the industrial policy of another country, leading to conflicting legal requirements upon firms.

106. Thus, there are strong common interests among countries in strengthening multilateral co-operation in the area of competition in a manner which would take account of each country's concerns and which would minimize tensions arising from unilateral action. This would not require the harmonization of competition policies or the creation of a supra-national competition authority, but rather could involve moving towards greater convergence in trade-related aspects of competition policies, co-ordinated enforcement, mutual assistance and a system for the allocation of jurisdiction amongst national competition authorities in appropriate cases. Consultations among Governments on the appropriateness of, and modalities for, the strengthening of bilateral, regional and multilateral consultations and cooperation in the area of competition policy should also take into account linkages with policies towards foreign direct

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[103] See the Concentration study.

[104] See Brainard R., "Internationalising R & D", OECD Observer, February/March 1992.

investment and trade. The increasing number of countries adopting competition policies would make them valid interlocutors in this field and the consultations machinery provided for under the RBPs Set could be a suitable modality for such discussions.